

Essential Utilities, Inc.

WTRG: ALJ Recommendation a Setback but DELCORA Deal Far from Dead

Reiterate Overweight

Overweight/\$52

Water Utilities

Company Note

• **Key Points.** The ALJ recommendation in the pending DELCORA deal was posted to the PaPUC website on 1/12. It recommends denial as (1) ongoing litigation regarding DELCORA's ability to transfer assets under the asset purchase agreement and (2) failure to attach the rate stabilization plan to the application make it too difficult to make an informed recommendation regarding if the deal is in the public interest. WTRG plans to file objections. This is no doubt a setback but in no way does it appear to kill the DELCORA deal. For starters, it does not necessarily convey the PaPUC commissioners' view (the PaPUC order is due by 3/26). We believe there is still a reasonable pathway to approval – perhaps through settlement – however it could push deal closure beyond early Q2'21. Reiterate Overweight.

• **Ongoing Litigation.** These lawsuits are separate from the 12/28 ruling in favor of DELCORA/WTRG regarding the APA's validity and ability to put the \$210M of net proceeds into a trust. Rather five of the 49 municipalities served by DELCORA (represent 9% of annual revenues) have not yet consented to the transfer of the assets and/or assignment of contracts to WTRG – though WTRG reached a settlement on 1/8 with one (Trainer) resolving its issues. Three of the munis (SWDCMA, Lower Chichester and Upland) filed lawsuits in early November in the Delaware County Court of Common Pleas.

• **Path Forward.** At this time it is unclear to us what the path forward would be if settlements are not reached with the remaining four munis and/or the section of the APA that contemplated such a scenario is not upheld/enforced. Can they be carved out of the deal? Once those issues are resolved, the reasonableness of the purchase price under PA's FMV law as well as the public interest determination can be made. The ALJ indicates a new application should be filed to reflect those updates along with the rate stabilization plan and tariff provisions outlining the bill credit mechanism to limit customers' rate increases to a 3% compound annual maximum (so long as the trust remains solvent). If a new application is indeed required, we believe it would push the potential closing date to late '21 or early '22.

• **Reiterate Overweight.** First, getting the \$277M DELCORA deal closed is more important than the timing. The near-term EPS impact is minimal. The strategic value is longer-term, including the fact that the bulk of DELCORA's \$700M capex needs through '28 fall in the 2026-28 period. Second, our Overweight thesis is not solely predicated on DELCORA closing. As previously stated, though the DELCORA deal is highly supportive of WTRG's growth aspirations, we consider the future to be bright without it, driven by elevated pipeline infrastructure investment needs for the foreseeable future supplemented by municipal M&A trends. We believe relatively low risk, regulated EPS growth of at least 6% is achievable and that rate of growth would simply be enhanced if DELCORA closes.

\$	2019A	2020E	2021E
EPS		Curr.	Prior
Q1 (Mar.)	0.28	0.60 A	NC
Q2 (June)	0.37	0.29 A	NC
Q3 (Sep.)	0.48	0.23 A	NC
Q4 (Dec.)	0.34	0.46	NC
FY	1.47	1.58	NC
CY	1.47	1.58	1.67
FY P/EPS	31.9x	29.7x	28.1x
Rev.(MM)	890	1,931	2,055

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
 NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
 V = Volatile
 Adjusted EPS excludes items considered non-recurring.
 WTRG expects 2021 adjusted EPS of \$1.64-1.69 range and targets a 5-7% EPS CAGR through 2023 off the 2019 adjusted base of \$1.47.
 WTRG expects 2020 adjusted EPS at the top end of the \$1.53-1.58 range.

Ticker	WTRG
Price Target/Prior:	\$52/NC
Price (01/13/2021)	\$46.88
52-Week Range:	\$30-55
Shares Outstanding: (MM)	245.2
Market Cap.: (MM)	\$11,495.0
S&P 500:	3,809.84
Avg. Daily Vol.:	923,308
Dividend/Yield:	\$1.00/2.1%
LT Debt: (MM)	\$5,277.4
LT Debt/Total Cap.:	53.2%
ROE:	9.0%
3-5 Yr. Est. Growth Rate:	7.0%
CY 2021 Est. P/EPS-to-Growth:	4.0x
Last Reporting Date:	11/03/2020
	After Close

NC = No Change
 Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

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Please see page 3 for rating definitions, important disclosures and required analyst certifications. All estimates/forecasts are as of 01/14/21 unless otherwise stated. 01/14/21 05:39:16 ET

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Together we'll go far



Acronyms:

ALJ – Administrative Law Judge
APA – Asset Purchase Agreement
DELCORA – Delaware County Regional Water Quality Control Authority
FMV – Fair Market Value
PaPUC – Pennsylvania Public Utility Commission
SWDCMA – Southwest Delaware County Municipal Authority

Price Target

Price Target: \$52 from NC

Our \$52/share price target reflects both a P/E multiple and DDM analysis. In terms of P/E, we apply a 70% water/30% gas utility hybrid multiple to our 2022E of \$1.80. For WTRG's water utility multiple, we ascribe a roughly 5% discount to the 21E multiple we use for AWK (34-34.5X, which is a 5-10% premium to the pure play water peer group median). We consider AWK to be WTRG's closest peer on the water side based on scale, key states/regions and municipal consolidation strategies. The roughly 5% discount reflects a modestly lower earnings growth rate (we forecast roughly 7% for WTRG's water business vs. 8% for AWK) as well as lower ESG appeal (primarily due to the Peoples gas utility). For WTRG's gas utility multiple, we utilize the 21E pure play gas LDC median of 17.0-17.5X (based on ATO, NWN, OGS & SR) and then apply a roughly 10% premium to it. We believe a premium is warranted as (1) Peoples is at the early stages of a multi-year accelerated pipeline replacement effort which is expected to drive healthy rate base growth for the foreseeable future (WTRG's 3-year guidance is 8-10%), (2) we believe Western PA, which sits above the prolific Marcellus and Utica shale plays, is largely immune to the anti-gas sentiment impacting some areas of the country and (3) most of Peoples falls under the constructive PA regulatory framework. Key risks relate to regulatory, Peoples gas deal integration and M&A strategy execution.

Investment Thesis

Our Overweight rating is premised on our belief that WTRG shares do not fully reflect the company's strong fundamentals which include a proven EPS growth strategy, a rate base that is growing at a mid-to-upper single digit CAGR, constructive regulatory treatment (particularly in PA where roughly 70% of earnings are derived and near-term regulatory risk is low as both the water and gas utilities completed rate cases in 2019), an efficient operating model and a solid financial profile. We believe relatively low risk, regulated EPS growth of at least 6% is achievable driven by the timely rate recognition of elevated pipeline infrastructure investment needs for the foreseeable future supplemented by water/wastewater municipal M&A trends.

Company Description

Headquartered in Bryn Mawr, PA, Essential Utilities (WTRG) - formerly Aqua America - is one of the largest U.S.-based investor-owned regulated water and wastewater utilities. The company serves approximately 3 million residents (1 million customer connections) in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, Indiana and Virginia. WTRG's largest subsidiary, Aqua Pennsylvania, accounts for approximately half of the company's total water customer base and nearly 70% of consolidated water rate base. Going forward, the company has expressed a desire to accelerate customer growth through a more active and focused acquisition strategy across its entire portfolio.

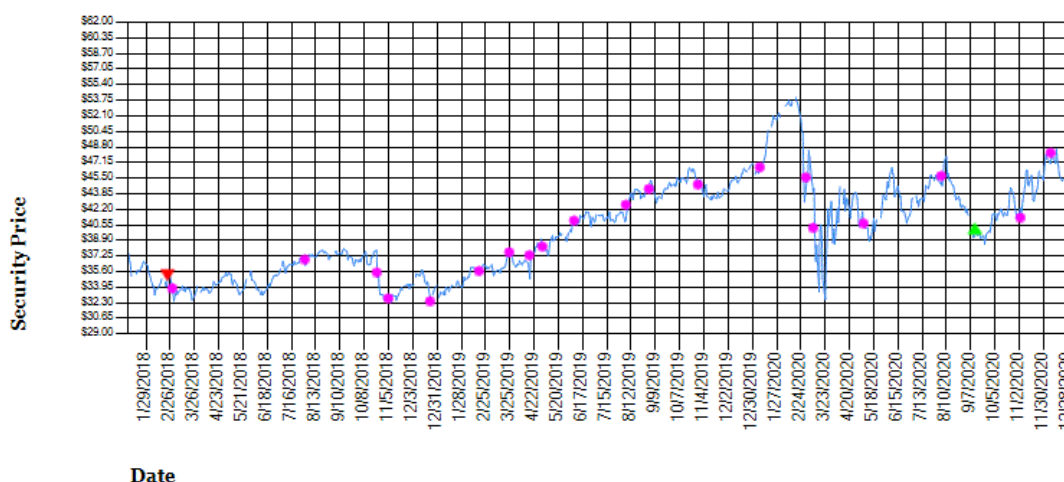
In March 2020, WTRG closed on the acquisition of Peoples - a predominately Pennsylvania-based gas utility serving 740k customers - from SteelRiver Infrastructure Partners for an enterprise value of \$4.275B (includes \$1.3B of assumed debt). From a price perspective, WTRG paid 1.9-2.0X rate base, 14.8X EV/EBITDA and nearly 25X P/E - lofty multiples but not that dissimilar to other gas utility transactions at the time. Management expects the deal to be EPS accretive in the first full year after close (2020) but stressed this is a strategic-driven, not synergy-driven, transaction.

Regulated operations account for more than 99% of consolidated revenues. Consolidated EPS is expected to be driven roughly 70% by water utility operations with the gas utility contributing the remaining 30%.

In February 2020, the new name Essential Utilities, Inc. and new ticker WTRG became effective. Prior, the company was known as Aqua America Inc. and traded under the ticker WTR.

Required Disclosures

Essential Utilities, Inc. (WTRG) 3-yr. Price Performance



Date	Published Price (\$)	Rating Code*	Price Target	Val. Rng. Low	Val. Rng. High	Close Price (\$)
1/8/2018		Reeder				
1/8/2018	NA	1	43	NE	NE	37.71
▼ 2/25/2018	35.00	2	37	NE	NE	35.00
◆ 3/1/2018	34.19	2	36	NE	NE	33.66
◆ 8/2/2018	36.70	2	38	NE	NE	36.70
◆ 10/24/2018	35.01	2	37	NE	NE	35.29
◆ 11/6/2018	32.70	2	35	NE	NE	32.59
◆ 12/24/2018	33.87	2	34	NE	NE	32.38
◆ 2/19/2019	35.54	2	36	NE	NE	35.52
◆ 3/26/2019	37.52	2	39	NE	NE	37.52
◆ 4/18/2019	36.52	2	38	NE	NE	37.15
◆ 5/3/2019	37.85	2	39	NE	NE	38.09
◆ 6/9/2019	40.84	2	42	NE	NE	40.84
◆ 8/8/2019	42.06	2	44	NE	NE	42.47
◆ 9/2/2019	44.29	2	47	NE	NE	44.29
◆ 10/29/2019	44.90	2	46	NE	NE	44.68
◆ 1/8/2020	46.51	2	48	NE	NE	46.51
◆ 3/2/2020	43.01	2	45	NE	NE	45.44
◆ 3/11/2020	44.41	2	48	NE	NE	40.03
◆ 5/7/2020	40.49	2	42	NE	NE	40.53
◆ 8/6/2020	45.56	2	45	NE	NE	45.56
▲ 9/14/2020	39.35	1	45	NE	NE	39.82
◆ 11/4/2020	41.19	1	47	NE	NE	41.19
◆ 12/10/2020	47.70	1	52	NE	NE	48.02

*Effective December 7, 2019, Wells Fargo Securities' Equity Research modified its ratings definitions. Complete definitions of current ratings can be found below. For information related to prior ratings definitions, please contact equityresearch1@wellsfargo.com.

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

▼ Rating Downgrade

▲ Rating Upgrade

◆ Price Target/Val Range Change

◆ Initiation, Resumption, Drop or Suspend

■ Analyst Change

□ Split Adjustment

Rating Code Key

1 Overweight/Buy SR Suspended

2 Equal Weight/Hold NR Not Rated

3 Underweight/Sell NE No Estimate

Additional Information Available Upon Request

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WTRG: Key risks relate to regulatory, Peoples gas deal integration and M&A strategy execution.

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3=Underweight: Total return on stock expected to lag the Overweight- and Equal Weight-rated stocks within the analyst's coverage universe over the next 12 months. SELL

VOLATILITY RATING

V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: January 14, 2021

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